

IN THE
Supreme Court of the United States

Supreme Court, U. S.

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No. 76-119

KLINE D. STRONG,
Petitioner,

vs.

K. JAY HOLDSWORTH and
DONA S. HOLDSWORTH,
Respondents.

RESPONDENTS' BRIEF IN OPPOSITION

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STATEMENT OF THE CASE

This is an action commenced by respondents against petitioner for rescission of a sale of stock in a closely held Utah corporation. Respondents based their action on violations of Rule 10b-5, its enacting federal statute, and common law fraud under state law.

The District Court, sitting without a jury, found in favor of respondents on both the federal claims and on the state common law claims and ordered petitioner to return the stock to respondents. (Pet. App. B).

Petitioner appealed to the Tenth Circuit Court of Appeals where the case was argued before a panel of three circuit judges. In a two to one decision the Circuit Court

reversed the judgment of the trial court on both the federal 10b-5 claims and the common law fraud claims. (Pet. App. C).

Respondents petitioned and were granted a rehearing *en banc*. All seven judges of the Tenth Circuit Court of Appeals, except the Chief Judge, participated in rehearing. Of the six judges participating, all six affirmed the District Court's findings of common law fraud under state law. Three of the judges declined to join the majority opinion affirming the finding of liability under Rule 10b-5. (Pet. App. D).

Respondents adopt the findings of the Circuit Court of Appeals sitting *en banc* as the correct statement of facts. The Circuit Court of Appeals found the following:

"Plaintiff-Appellees prevailed in an action for rescission of a sale of stock. Appellant Kline D. Strong was found to have made the sale by using false representations and fraudulent devices. The suit was brought pursuant to Section 10b of the Securities and Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. Recovery was also obtained on a parallel claim in common law fraud.

"The Holdsworths, husband and wife, sold their shares of stock in a closely held corporation called Sans-Copy to Strong, who had owned the majority of the stock in this corporation. Strong persuaded them to sell the stock, generally representing that the company was unable and would be unable to pay dividends. In truth, the company was continuously increasing its volume and had demonstrated earning capacity.

"The cause was tried to the court as an equity case, the Holdsworths' demand for a jury trial having been denied. It required four days to complete. At the end of the trial the judge announced from the bench that there was clear evidence of fraud of the elements of a common law fraud case under the law of Utah. He then set forth his findings in oral form. These were later incorporated in a formal set of findings of fact and conclusions of law which were signed December 1, 1974. Strong did not seek a new trial nor did he challenge the findings and conclusions in the trial court. Instead he appealed at once to this court.

"Both Kline D. Strong and the appellee K. Jay Holdsworth are attorneys; Holdsworth is an accountant as well. Paul Tanner, who was also a part of the enterprise in question, was and is an accountant. The mentioned parties formed the subject corporation. Its purpose was to develop, manufacture and sell time-keeping systems for law offices. Originally there were 60 shares of common stock which were divided equally among the three incorporators and their wives. Each couple paid \$300 for 20 shares. It was contemplated at the outset that all three would participate in the management of the corporation. It did not work out as planned, however; Mr. Strong ended up in complete charge of the business. In its initial stages he performed research and other preliminary work developing the idea and introducing it to the legal profession. Essentially, it was a simple system for recording the time spent by lawyers working for clients.

"In July 1959, Sans-Copy entered into an agreement with Reynolds and Reynolds granting to the latter the exclusive right to manufacture and market the system

except in Utah. Under the agreement Sans-Copy was to receive a royalty of 30 percent on gross sales and Strong was to promote the time-keeping system at bar association conventions and meetings. It was as a result of this change of condition that the shares in the corporation were changed; Strong informed Holdsworth that since he was doing most of the work he believed that he should own a controlling interest. Holdsworth and Tanner agreed to this, and as a result Strong was given 52 shares of the 100 shares of the outstanding stock in the corporation.

"The details of the Sans-Copy process is not of primary importance, but a brief description will help general understanding. It was and is a method for recording and keeping records of the time spent by a lawyer on a client's case. It furnishes a daily log as well as separate slips to be sorted for use in determining bills. The system was intended to provide an easy way for lawyers to keep time sheets and to prevent double or triple entry accounting.

"Strong was being paid compensation for his efforts, and Holdsworth and Tanner were given some shares of newly created stock which provided for them to get a small dividend annually. These dividends were paid irregularly in the Class A common stock until 1970, at which time they were abruptly terminated. (Footnote omitted).

"After 1962, there were neither board meetings nor financial statements furnished to Holdsworth and Tanner. Holdsworth did not participate in the management of the corporation and his knowledge was restricted to information furnished by Strong.

"In 1971, Strong notified Holdsworth and Tanner that

the company had invaded capital in issuing 1970 dividends. For that reason they were told that no dividends would be forthcoming at that time.

"Holdsworth and Strong also owned a ranch, and subsequently, in January 1972, during the course of a conversation between Strong and Holdsworth having to do with the ranch, Strong offered to buy the Holdsworth shares for \$1,500. Strong at that time represented to Holdsworth that the corporation would never pay dividends in the future. He repeated this oral statement in a letter to the Holdsworths a short time later. Based on that statement and others, the Holdsworths sold their shares for \$1,500 and a general release. In the same year, Holdsworth learned that Sans-Copy had realized a gross income exceeding \$100,000 and his knowledge moved them on May 17, 1973, to give notice of rescission. When Strong rejected this attempt, they started the present suit on May 31, 1973. Their claims were based on the following material representations and omissions (summarized and paraphrased hereafter):

"Strong's statement that it was unlikely that dividends would be paid in the future; that the corporation was unable to pay present or future dividends on the preferred shares; omission by Strong to state material facts necessary to render the statements non-misleading; that at the end of the fiscal year ending November 30, 1971, Sans-Copy had gross receipts in excess of \$96,000; gross receipts were increasing each year since 1969; Sans-Copy was a growing enterprise; deductions were unnecessarily excessive and improper and many of these were paid to Strong and his relatives; that Strong had borrowed from the corporation and not repaid the loans; furthermore, that the \$1,500

was an unfair price in light of the earnings of the corporation and its growth potential. It was also alleged that Strong had employed schemes and devices to defraud, had engaged in acts, practices and a course of business which had operated as a fraud and had breached his fiduciary responsibilities to the Holdsworths, violating their special relationship of trust and confidence.

"After a trial to the court, it was ordered that Strong return the common stock and the reversions in the Class A common stock to the Holdsworths.

The Trials Court's Findings

"In the trial court's findings of fact and conclusions of law it was brought out that the Holdsworths and Strong were close friends and that this had been an important element in their entering into the enterprise. The trial court also considered some of the excessive expenditures which had been made by Sans-Copy to Strong's law firm. Excessive loans made to Strong from Sans-Copy funds were detailed. Amounts paid to Strong's immediate family and payment of personal expenses to Strong from the funds of Sans-Copy without approval or authorization of Holdsworth or Tanner were pointed out as was payment of funds to Strong and his law firm in 1971 charged as attorney's fees but for which no legal services had been rendered.

"The court also found that:

"In 1970-71, the net worth of Strong was shown to have increased substantially; the defendant had misrepresented that there had been an invasion of capital in the payment of dividends in 1970.

"There was in fact a surplus for that year. During 1971, Strong had diverted a large sum of money from Sans-Copy to a non-profit corporation, Utah Law Research Institute, of which he was the organizer and executive director.

"In 1971, defendant diverted funds from Sans-Copy to make restitution to the profit sharing plan of his law firm; no legal services were rendered to Sans-Copy for this payment of \$4,570.

"During the year 1971, the net worth of appellant Kline Strong increased \$262,000 which, after adjustments claimed by appellant, showed an increase of \$112,000.

"Notwithstanding the foregoing, the trial court found, appellant maintained that Sans-Copy was unable to pay dividends and would be unable to pay dividends in the future. Representations in Strong's letter to Holdsworth offering to buy him out were knowingly false statements relied on by the Holdsworth in accepting the offer to buy their stock.

"The sale of the stock without examination of the books was held to be excusable in view of the friendly relationship of the parties, being engaged in the ranching business together as well as Sans-Copy. The books and records, according to the further finding of the court, failed to accurately reflect the condition of the company; they were incomplete and had been adjusted and revised by the defendant. So examination would not have been helpful in learning the truth.

"The court determined that the evidence was clear and convincing that false representations were made by

defendant concerning the present facts, which representations the defendant knew to be false and which representations were made for the purpose of inducing the plaintiffs to sell their stock and that the plaintiffs did sell their stock acting in reliance upon the representations made and in the belief that the representations were true.

"The court's conclusions of law emphasized that the defendant knowingly and intentionally made false representations of present existing facts concerning the shares of stock of Sans-Copy for the purpose of inducing plaintiffs to sell their shares, and the plaintiffs sold their shares in reliance on the representations and that they acted reasonably under the circumstances of the case and the relationship of the parties and in ignorance of the falsity of the representations. The court concluded that there had been a violation of Section 10b and Rule 10b-5 of the Securities and Exchange Act of 1934, all of which entitled the plaintiffs to restitution."

ARGUMENT

The Petition for Writ of Certiorari does not demonstrate any valid reason for review of the *en banc* decision by this Court.

The decision of the trial court can be sustained on state law grounds without consideration of the federal issues. Indeed the Circuit Court *en banc* unanimously affirmed the decision on state law grounds.

The "questions presented" by petitioner are based upon erroneous interpretations of the Tenth Circuit Court *en banc* opinion and upon erroneous interpretations of other

circuit and state court decisions. There is neither a conflict among the circuits, an important question of federal law which has not been settled by this Court, nor a conflict with the decisions of this Court. Petitioner attempts to characterize the *en banc* decision as involving novel legal theories while in actuality the Circuit Court merely applied well recognized and established judicial standards to what is essentially a factual dispute.

A. *The Tenth Circuit Court of Appeals Is Not In Conflict With Any Other Court Nor Has It Eliminated A Scrutiny Of A Plaintiff's Own Actions.*

The Tenth Circuit in its opinion stated the following:

Inasmuch as the defendant does not challenge the general sufficiency of the evidence but rather bases his demands for reversal on alleged trial error, we address our comments to the specifics but, at the same time, *note in passing that substantial evidence of intentional fraud and deceit is present.* (Pet. App. D, p. 50) (Emphasis added).

The petitioner throughout the appellate process has not questioned the sufficiency of the evidence showing clear and intentional fraud. Rather, he claims that the Tenth Circuit and Third Circuit courts are in disagreement as to the standard to be applied to the conduct of the ones defrauded. There is no such disagreement.

Petitioner contends that *Straub v. Vaisman & Co., Inc.*, 540 F.2d 591 (3rd Cir. 1976) is in direct conflict with the Tenth Circuit *en banc* opinion. *Straub* concerned a security transaction between a German corporation and a New York securities broker-dealer. The trial court in *Straub* based

its decision on defendant's failure to disclose material information. 540 F.2d at 594. *Straub* is therefore factually distinguishable from the case at bar since the trial court in this case found that "defendant knowingly and intentionally made false and fraudulent misrepresentations." (Pet. App. A, p. 24). This Court has held that omission cases are judicially distinguishable from misrepresentation actions because of the differing elements of proof required in each type of case. *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972). Thus, it is highly questionable whether *Straub* is even properly comparable with the instant case. In any event, however, the *Straub* decision is not in conflict with the Tenth Circuit *en banc* opinion.

In *Straub* the trial court awarded the plaintiffs \$38,000 and concluded that the actions of defendant were "shocking to the conscience of this Court." The Third Circuit Court characterized the defense presented as "defendant's [attempt] to focus solely upon the plaintiff's conduct and thus escape liability despite the intentional scheme to defraud." 540 F.2d at 596. There, as here, the defendants did not contest their fraudulent schemes but merely tried to shift responsibility to the plaintiffs for failing to discover those fraudulent schemes.

The Third Circuit Court recognized the scienter requirement set forth in *Ernst & Ernst v. Hochfelder*, 425 U. S. 185 (1976). Discussing the effect this requirement has upon the "due diligence" defense, the court stated:

[S]ince *Ernst & Ernst v. Hochfelder*, supra, has limited 10b-5 actions to those in which the defendant has a mental state "embracing intent to deceive, manipulate or defraud" the desirability of a "contributory negligence" defense becomes less compel-

ling. In determining the scope of the due diligence defense, we look to two considerations, common law derivations and deterrence of investor carelessness. 540 F.2d at 597.

• • •

The analogy to the common law torts indicates that since intent to defraud is a necessary element of a 10b-5 action, the due care defense should be narrowly circumscribed. Under the common law, once the right to recover for intentional misrepresentation has been established, lack of care on the part of the recipient in accepting the representations as true becomes irrelevant so long as the misrepresentation is not patently false. W. Prosser, *Handbook of the Law of Torts* §108 (4th ed. 1971); *Restatement of Torts* §§540, 541 (1938). Moreover, against the background of common law negligence, where the doctrine of comparative negligence is in the ascendancy, the policy of denying all recovery to a defrauded plaintiff who was only somewhat careless or undestandably trusting may be questioned. *Id.* at 597.

Similarly, in the Tenth Circuit Court of Appeals *en banc* opinion it is said:

Use of a tort analogy plainly demonstrates the inappropriateness of due diligence in 10b-5 suits under *Ernst & Ernst* doctrine, for the due diligence standard as applied to 10b-5 suits is about the same as the application of contributory negligence. Just as contributory negligence is not a defense to an intentional tort case of fraud, similarly, due diligence is totally inapposite in the context of intentional conduct to be proved under Rule 10b-5. (Pet. App. D., pp. 55-56).

The Tenth Circuit Court in this case cited the *Straub* opinion in reaching its decision. (Pet. App. D, p. 54).

Both, the Third Circuit and Tenth Circuit Courts agree that due diligence has but limited, if any, application to intentional fraud cases.

The criteria used by both courts in reviewing a plaintiff's conduct are identical. The Third Circuit Court stated that the circumstances of each case must be carefully examined, and that the burden of proof rests upon the defendant to show unreasonable behavior on the part of the plaintiff, saying:

Such matters as fiduciary relationship, opportunity to detect the fraud, sophistication of the plaintiff, the existence of long standing business or personal relationships, and access to the relevant information are all worthy of consideration. 540 F.2d at 598.

The Third Circuit, applying this standard, concluded that the trust of plaintiff in defendant's advice and the failure of plaintiff to have access to information "fully justifies the District Court's rejection of the lack of diligence defense." *Id.*

Similarly, the Tenth Circuit stated in its opinion that a plaintiff must be shown to have "justifiably relied" upon the fraud of a defendant and that a plaintiff "may not reasonably or justifiably rely on a misrepresentation where its falsity is palpable." In evaluating the justifiable reliance of a plaintiff, the court considered the same factors enumerated in *Straub*. The Tenth Circuit Court stated:

Not only were Holdsworth and Strong business friends, their friendship extended as well to their families. This explains why Holdsworth failed to challenge Strong's representations every step of the way, including the insistence of the purchase by Strong of the stock. This trust and confidence had

been carefully built up over a long period of time and had brought about the sale of the stock by means of a long-range machination. These factors furnished justification for the court to find that at the time of the sale of the stock Holdsworth was conditioned. In view, then, of the existence of justifiable reliance, and considering the added fact that an examination of the corporation's books would not have revealed the falsity of Strong's representations, we conclude that in the particular factual climate, justifiable reliance was a link sufficient to eliminate a need for the Holdsworths to show lack of contributory fault. (Pet. App. D, pp. 61-62).

Since the Third Circuit in *Straub* considered similar factors in evaluating the plaintiff's fault, it is highly probable that the Third Circuit would have reached the same conclusion in the instant case in view of the specific finding of the trial court that:

Plaintiffs acted reasonably under the circumstances of this case and the relationship of the parties and in ignorance of the falsity of said misrepresentations. (Pet. App. A, p. 24).

The claimed conflict among the circuits is completely illusory.

Petitioner's alleged fear that imprudent investors will be able to recover under 10b-5 and that investment information will cease to be made available are also unfounded. (Pet., pp. 8-9). The Securities and Exchange Commission filed its *amicus curiae* brief in support of the respondents' request for rehearing by the circuit. It is thus apparent that the SEC is in favor of the decision as rendered by the *en banc* court and that the court's interpretation of the 1934 SEC Act is not erroneous as is asserted by petitioner in his brief. (Pet. p. 9). There can be no doubt that the

Tenth Circuit Court of Appeals is concerned with the actions of plaintiffs in 10b-5 cases and will carefully scrutinize these actions to see if a plaintiff's justifiable reliance and causation is present in a given factual situation.

Petitioner's "first question presented" should be rejected by this Court.

B. The Tenth Circuit Court of Appeals Applied Correct Principles of Law in Reviewing Petitioner's Claim Concerning Proof of Damages.

Petitioner claims that the Tenth Circuit Court of Appeals erred in holding "that a plaintiff need not demonstrate any pecuniary injury in order to sustain a claim for rescission in a civil action under SEC Rule 10b-5." (Pet. p. 2) This contention both misconstrues the holding of the Circuit Court and the applicable rule of law.

This action sought rescission of a sale of stock by the seller, not money damages. As such, respondents did not need to show the actual monetary damage suffered, so long as some injury or detriment was proven.

The Circuit Court of Appeals found that the evidence justified the trial court's conclusion of injury, in that respondents were induced "to relinquish participation in an enterprise which would have yielded dividends had it not been for the diversion of funds" and "were deprived of interest in a capital enterprise that had both growth potential and profit potential." (Pet. App. D., p. 62).

The cases relied upon by petitioner involve actions for damages, not for rescission. (Pet. p. 10). Obviously, in an action for money damages, a plaintiff must prove the

amount of his damage. In rescission, however, such exactness is not necessary, since the stock itself is being sought and damage have been waived by the plaintiff in favor of the potential benefits to be gained by the repossession of the stock. The authorities agree that the amount of monetary damages need not be shown in rescission actions. Williston, *Contracts*, §1525; III Pomeroy, *Equity Jurisprudence*, §898 (§A), p. 535, 5th Ed.

Even the *Restatement of Torts* relied upon by petitioner (Pet. p. 10) is against his position. "Harm" is defined therein as the "existence of loss or detriment in fact of any kind to a person resulting from any cause." §7, p. 12. Both the trial court and the Circuit Court found sufficient evidence of harm to justify rescission.

Petitioner's "second question presented" should also be rejected.

C. The Court of Appeals and Trial Court Properly Applied Utah State Law.

As noted earlier, the *en banc* opinion unanimously held that petitioner had perpetrated common law fraud as defined by the Utah Supreme Court. Thus, regardless of any federal questions presented, the Circuit decision may be affirmed on this ground alone.

Petitioner claims that the court of appeals and trial court incorrectly applied Utah law to the claim of common law fraud. However, both the trial court and appellate court specifically found that all of the elements necessary to establish common law fraud under Utah law were present in the record (Pet. App. D., p. 64-65).

It is well settled that this Court should ordinarily accept the determination of state law made by the trial court and the court of appeals. *Commissioner of Internal Revenue v. Vouch*, 387 U.S. 456 (1967); *County of Allegheny v. Frank Mashuta Company*, 360 U.S. 185 (1959).

A recent Utah Supreme Court case succinctly states the law in cases where the carelessness of the plaintiff is claimed as a defense in actions based on actual fraud. The Utah Supreme Court stated:

The law does not generally approve nor give any advantage to one who intentionally deceives another, obstructs him from learning the facts, and then attempts to impute fault and responsibility to the other party for believing him. *Bezner v. Continental Dry Cleaners, Inc.*, 548 P.2d 898 (Utah 1976).

The Utah Supreme Court, as illustrated by *Bezner*, has always examined the factual context of the claimed actions of a plaintiff to determine if justifiable reliance is present.

It is apparent that the Utah Supreme Court in applying Utah law would find a clear case of common law fraud because petitioner had undisputably concealed material facts from respondents, had misused respondents' trust and confidence in him, and had attempted to conceal all evidence of the perpetrated fraud. The trial court's determination that, in view of these circumstances, a common law fraud case existed is supported by the record and by the decisions of the Utah Supreme Court.

For these reasons, petitioner's third and final questions presented should also be rejected.

CONCLUSION

For the reasons set forth above, the respondents respectfully submit that petitioner has failed to raise any issues meriting review by this Court. This case is essentially a factual dispute. It was resolved on state law grounds. The Petition for Writ of Certiorari should be denied.

Respectfully submitted,

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